

EX PARTE OR LATE FILED

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**PACIFIC**  **TELESIS**  
Group-Washington

February 12, 1997

**EX PARTE**

William F. Caton  
Acting Secretary  
Federal Communications Commission  
Mail Stop 1170  
1919 M Street, N.W., Room 222  
Washington, D.C. 20554

Dear Mr. Caton:

Re: CC Docket No. 96-262, Access Reform

On February 11 and 12, Rex Mitchell, Vice President, Pacific Bell, and I met with John Nakahata of the Office of General Counsel, Richard Metzger, John Garcia, James Schlichting and Jane Jackson of the Common Carrier Bureau, to discuss the attached materials in reference to the above docket. Please associate this material with the above referenced proceeding.

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's Rules.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,



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# **Universal Service and Access Reform Choices**

# The Problem -- Eliminating the Subsidy Implicit in LEC Rate Structures

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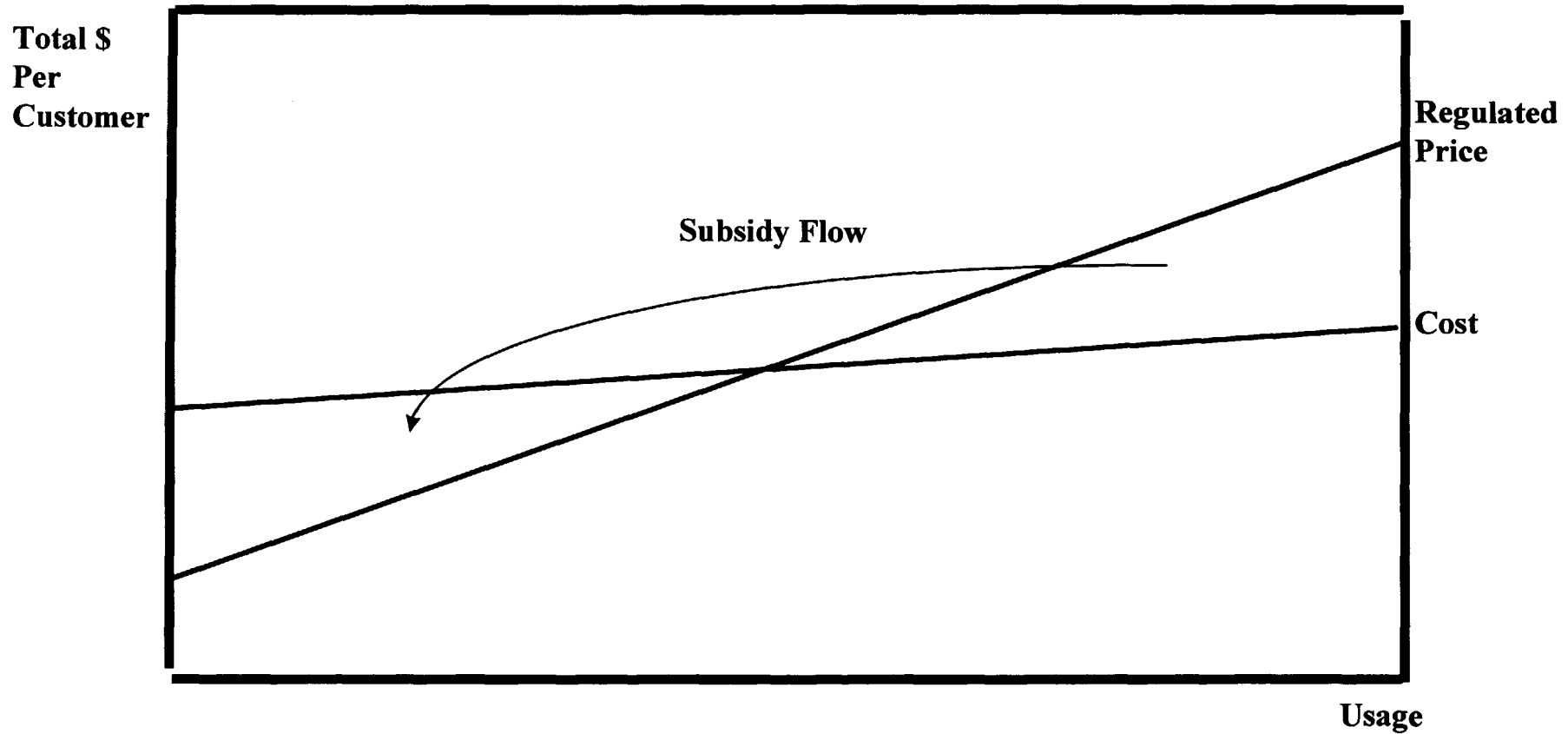
- Subsidy carried by only some suppliers is inconsistent with an *open market system*
- The dynamics of a competitive environment preclude the deliberate overpricing of certain products in order to extract contribution to support products priced below their cost
- Competitors will seek the most profitable, low cost areas to serve and force the price of competitive services towards their incremental cost (toll and access)
- Competitors will ignore markets where the incumbent's services are priced artificially low (basic service)

# Types of Subsidy

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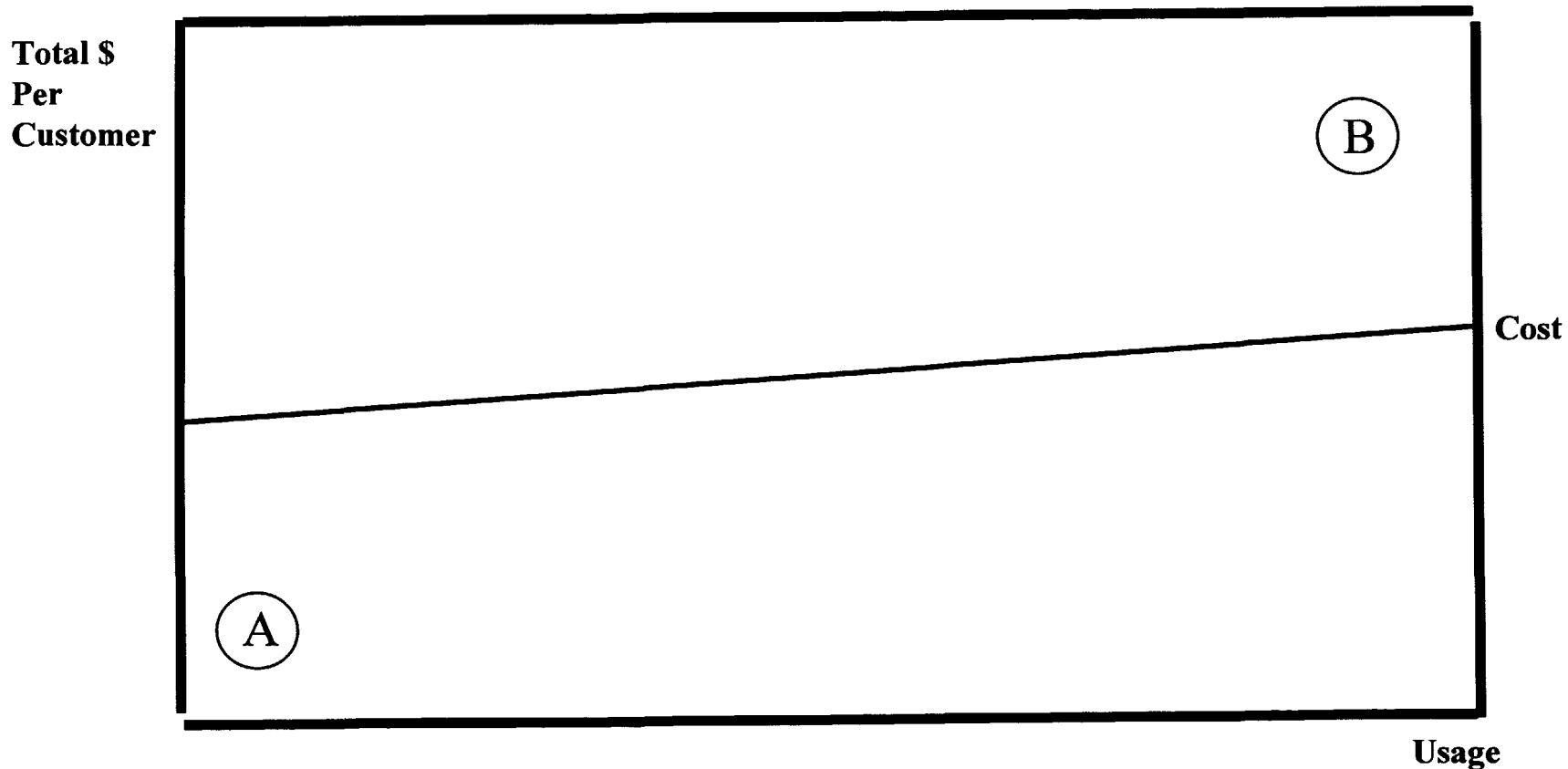
- **Product to product**
  - Products that generate revenues above incremental cost subsidize products priced below their incremental cost.
- **Geography to geography**
  - Profitable, low cost areas subsidize unprofitable, high cost areas.
  - Statewide average costing and pricing hides the enormity of this subsidy problem.
- **Customer to customer**
  - Profitable customers (generally heavy toll users) subsidize customers that do not generate enough revenues to cover the cost of their service mix.
  - **Subsidy within an exchange area**
  - Density within an exchange is never evenly distributed. Typically, an exchange may have density characteristics of an urban, suburban and rural area, all within the same exchange.

# The Subsidy Picture Today



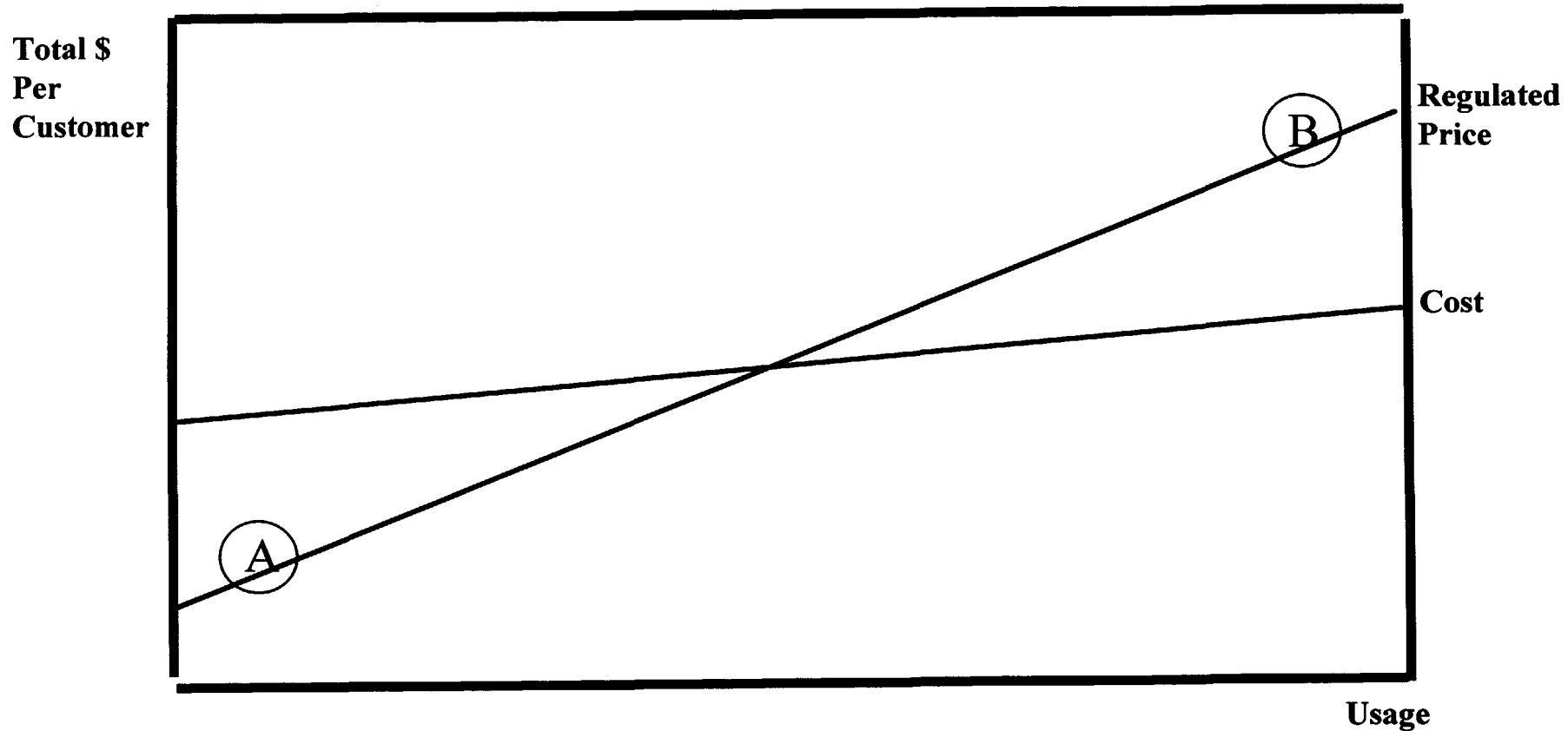
- *This is the price/cost distortion that exists today.*

# Cost Line



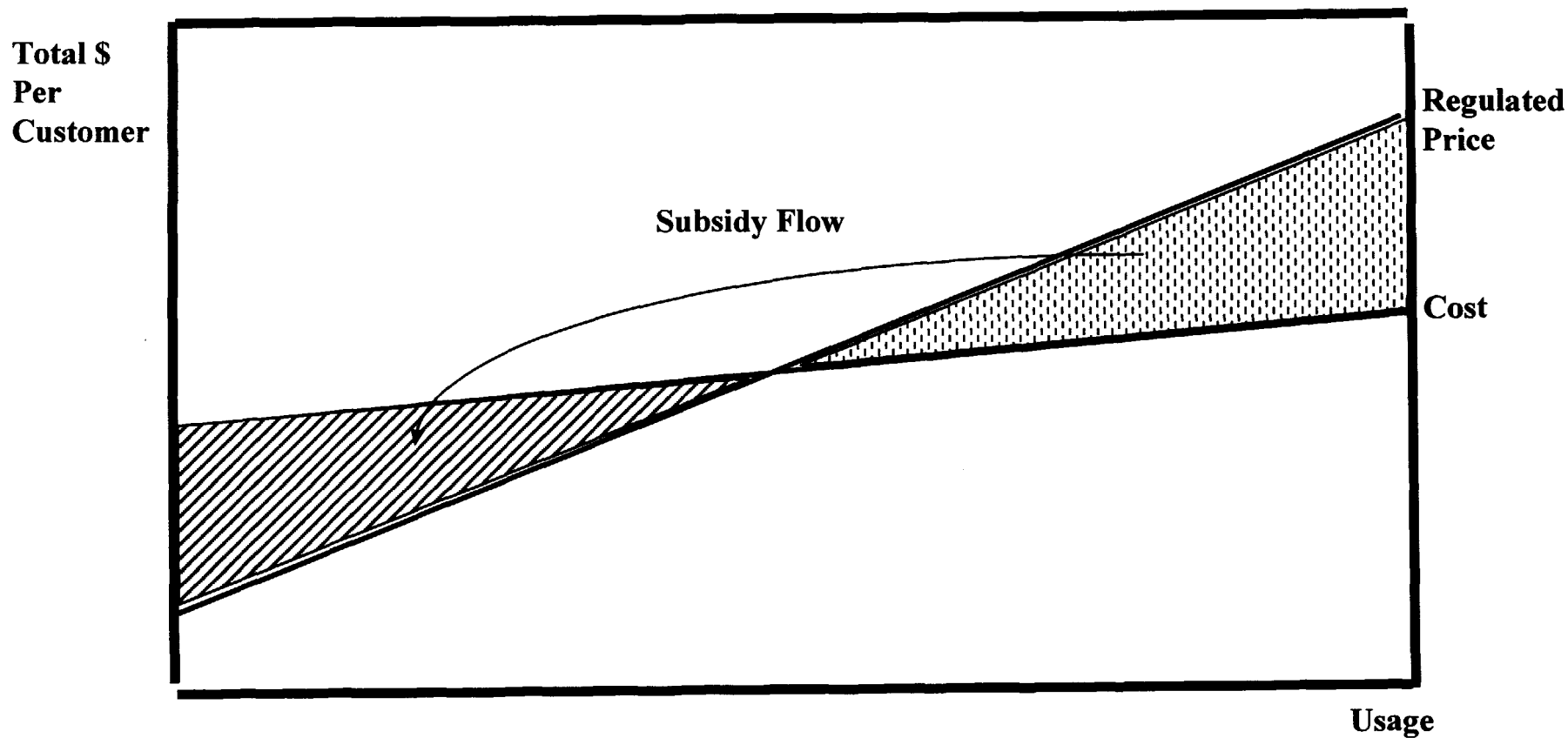
- Customers with no usage and no custom calling features, but are connected to the network, incur significant cost.
- A neighbor of that customer with very significant usage and vertical features incurs very little additional cost.

# Cost and Price



- If we super-impose our prices, low usage customers pay a low price relative to their cost, while the neighbor with significant usage and vertical features pays a vastly different price -- hence the steeply ascending line.

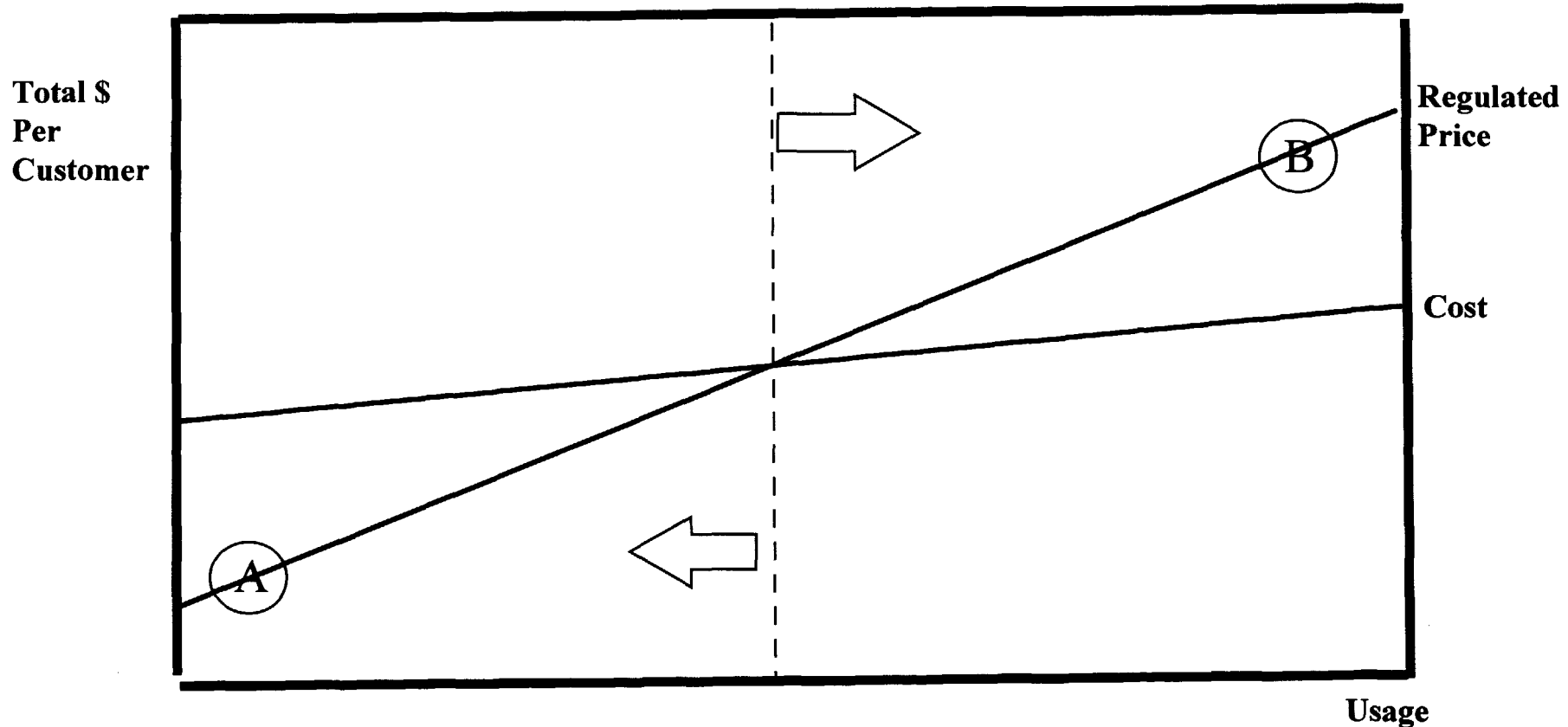
# Subsidy in a Regulated World



- In a regulated world without competition, all is in balance from the LEC's point of view. The cost/price relationship is satisfied.

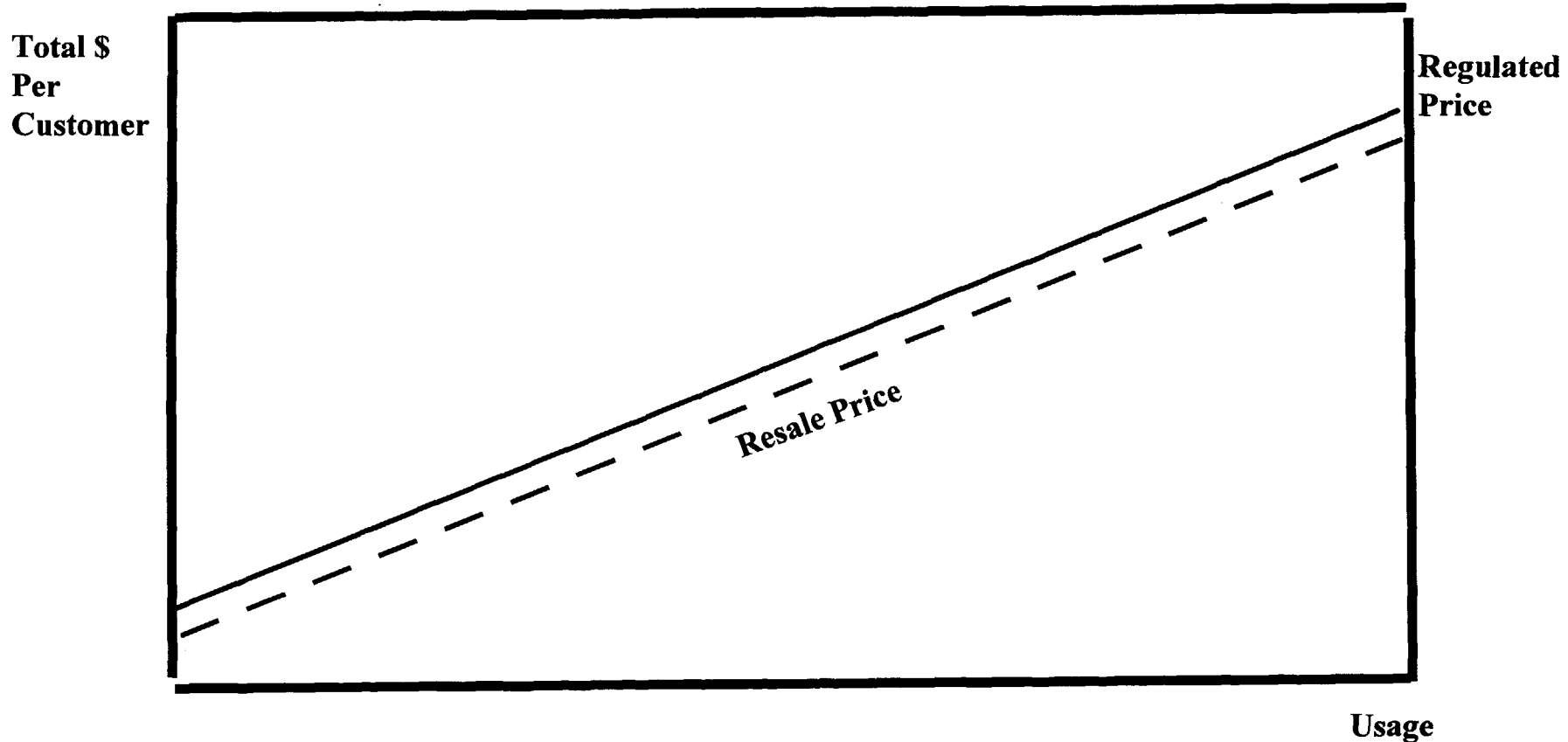


# Subsidy in a Competitive World



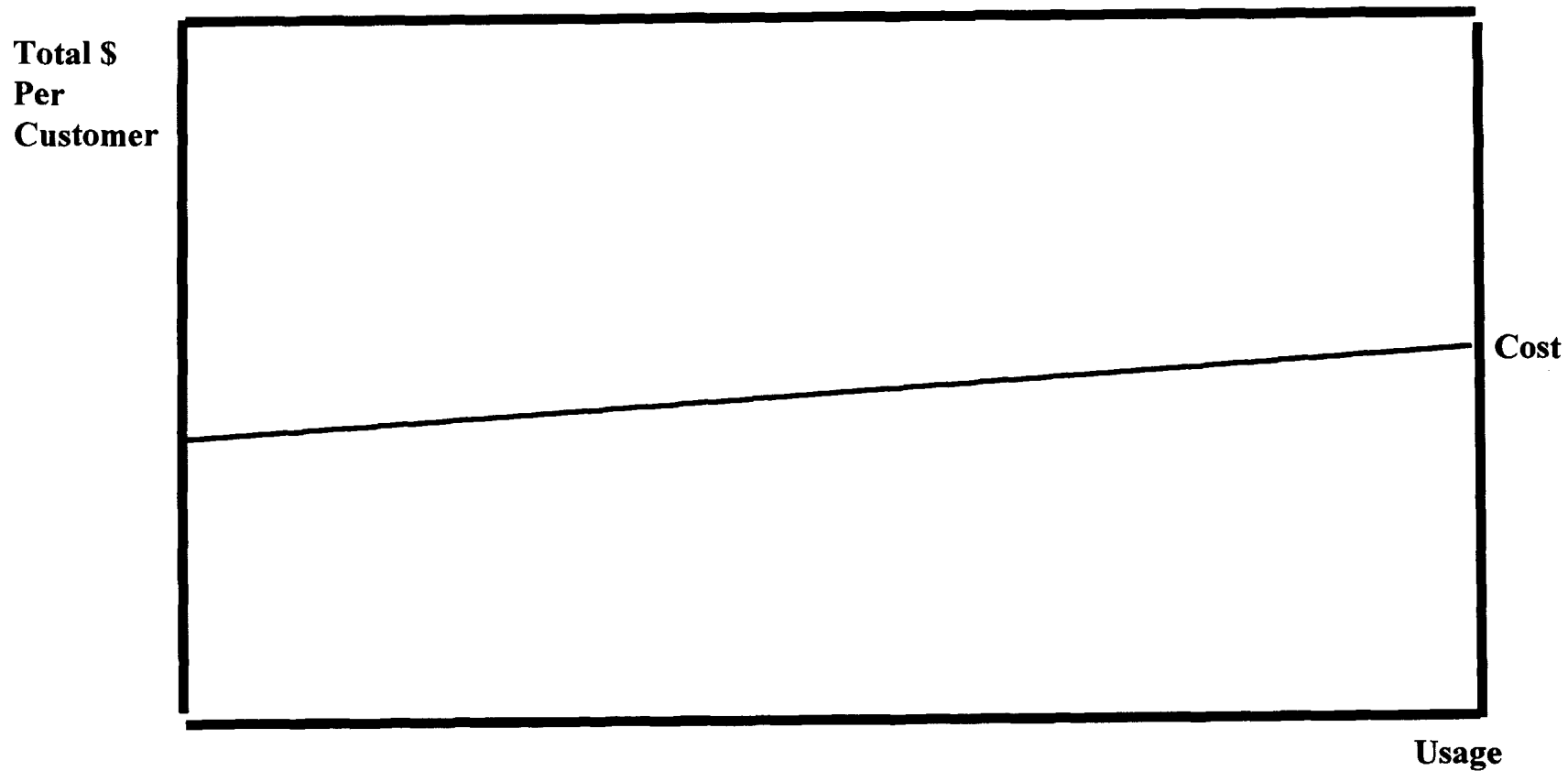
- Now enters the world of competition -- customers on the right side of the curve are *very* attractive while customers on the left side are not.
- In a world where competitors must build facilities to attract customers on the right side, they will incidentally pass customers on the left -- thus minimizing the cream-skimming opportunities

# Resale World



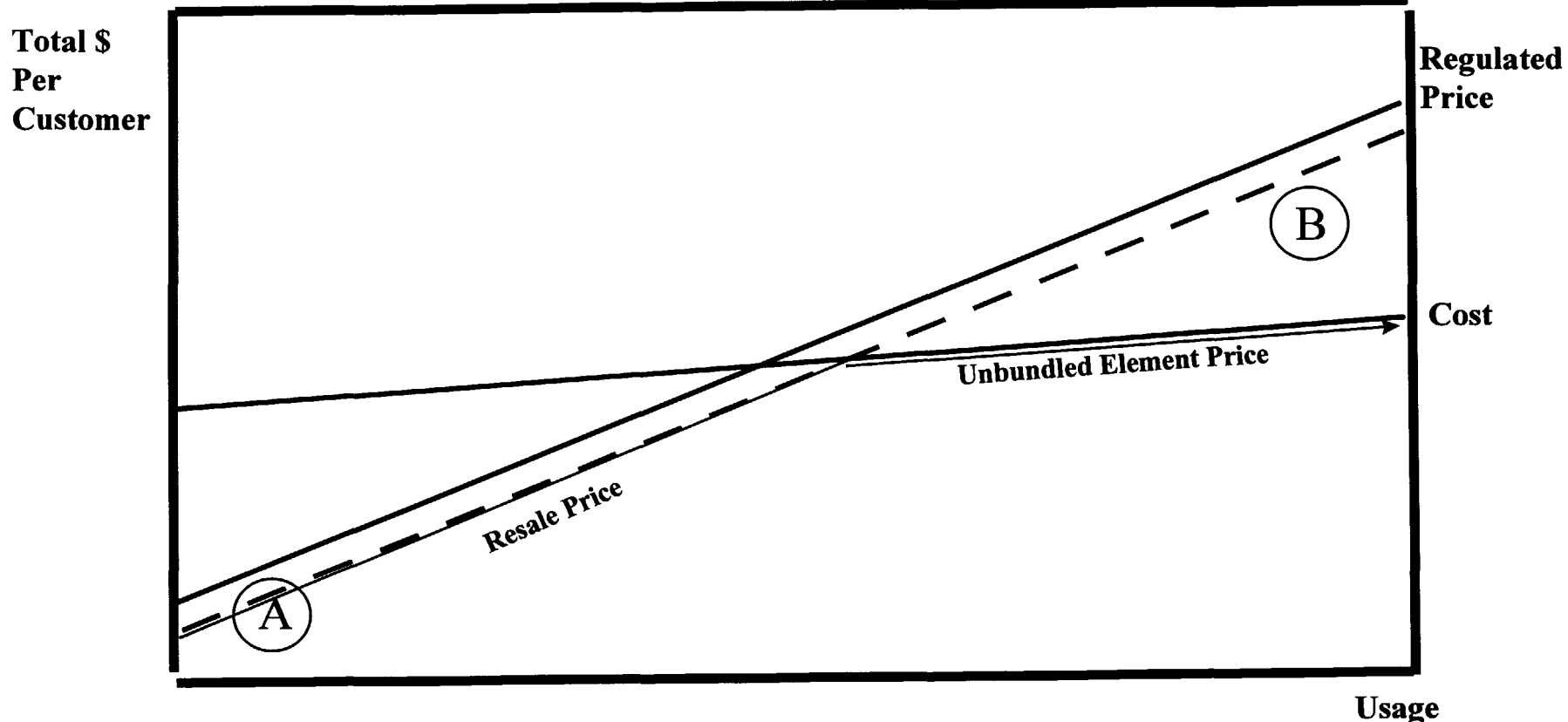
- With resale, the cost line disappears.
- Assuming the competitor does not build its own facilities, all customers are attractive to serve by the amount of the wholesale discount.

# Unbundled World



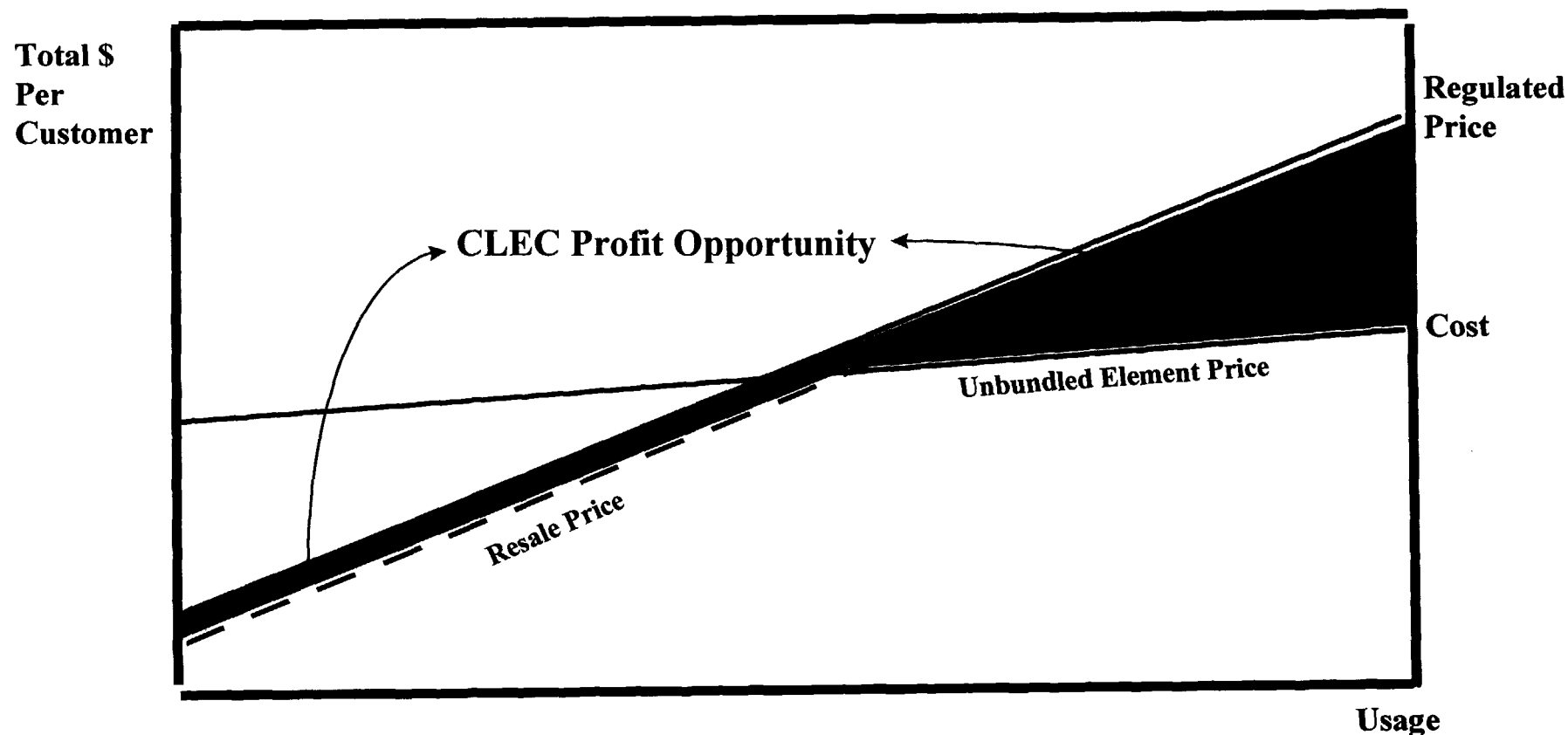
- In a world of unbundled elements, prices are irrelevant and the CLEC buys unbundled elements based on cost.

# The Best of All Worlds for CLECs



- Here, the CLEC gets to choose, on a customer-by-customer basis whether to use the resale discount or unbundled elements, giving them a tremendous cream-skimming opportunity.
- The optimal decision for a CLEC is to choose resale for *subsidized* customers to avoid paying the cost of the facility to serve those customers.
- For the high usage customer, the optimal decision for the CLEC is to pay the cost of the facilities and avoid contributing to the subsidy.

# The Worst of All Worlds For The LECs



- For the CLECs, *every* customer is attractive to serve with minimal or no investment required.
- The LEC is left with the cost of the facility and no means to support it.

# A Per-line Charge Decreases, But Does Not Eliminate the Price/Cost Distortions of Usage Sensitive Pricing

